

Message Text

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PASS: CEA, TREASURY, FRB

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SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE
(EDRC) REVIEW OF YUGOSLAVIA

REF: (A) EDR(77)10; (B) OECD PARIS 11676
(C) STATE 93997; (D) BELGRADE 2591

1. SUMMARY: AT APRIL 27 EDRC REVIEW, YUGOSLAV DEL (LED BY COLANOVIC, GOVERNOR OF CENTRAL BANK) UNDERLINED SIGNIFICANT PROGRESS ACHIEVED BY GOY IN 1976 IN IMPROVING CURRENT ACCOUNT POSITION AND PRICE PERFORMANCE. YUGOSLAVS DID NOT EXPECT GAINS MADE IN THESE AREAS IN 1976 TO UNRAVEL TO IMPORTANT EXTENT IN 1977 AND TOOK ISSUE WITH SECRETARIAT VIEW THAT EXCESS DEMAND COULD LEAD TO ACCELERATION OF INFLATION THIS YEAR. MOREOVER, THEY INSISTED THAT CURRENT ACCOUNT FOR 1977 COULD BE KEPT TO OFFICIALLY FORECASTED DEFICIT OF \$400 MILLION, DESPITE SHARP DETERIORATION IN FIRST QUARTER. SECRE-
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TARIAT, SWAYED BY YUGOSLAV ARGUMENTS SUPPORTING THEIR INFLATION FORECAST, AGREED TO MODERATE ITS PESSIMISTIC ASSESSMENT OF SHORT-RUN PRICE OUTLOOK, BUT CAUTIONED THAT GOY SHOULD GIVE PRIORITY ATTENTION TO REDUCING UNDERLYING RATE OF INFLATION. YUGOSLAVS EMPHASIZED THAT INCREASED INVESTMENT WOULD BE CRUCIAL TO ACHIEVEMENT OF GOY'S MEDIUM-TERM OBJECTIVES AND THAT MAJOR IMPEDIMENT

TO INVESTMENT WAS LACK OF EFFICIENT CAPITAL MARKET TO MOBILIZE AND DIRECT SAVINGS. IN THIS CONTEXT, COLANOVIC SAID THAT OECD AREA TECHNOLOGY AND CAPITAL WOULD BE IMPORTANT TO REALIZATION OF YUGOSLAVIA'S ECONOMIC POTENTIAL. END SUMMARY

2. SHORT-TERM PROSPECTS; DOMESTIC OUTLOOK FOR 1977: SECRETARIAT HAD INDICATED IN REF A THAT SHARP UPTURN IN DOMESTIC DEMAND IN FIRST QUARTER OF 1977 HAD ENTRAINED ACCELERATION OF INFLATION AND AUGERED ILL FOR ACHIEVEMENT OF OFFICIAL INFLATION TARGET (12 PERCENT AVERAGE RISE IN CONSUMER PRICES) FOR THE YEAR. YUGOSLAVS TOOK ISSUE WITH SECRETARIAT POSITION, ARGUING THAT (A) WHILE DOMESTIC DEMAND DID PICK UP AT END OF 1976, THIS TREND DID NOT CONTINUE IN FIRST QUARTER OF 1977 WHEN INDUSTRIAL PRODUCTION WAS FLAT; INVESTMENT SPENDING DECLINED AT ANNUAL RATE OF 20 PERCENT (AFTER RAPID INCREASE IN LATE 1975); AND CONSUMPTION DECLINED MODERATELY; (B) 53 PERCENT GROWTH OF M1 IN 1976 DOES NOT POSE SIGNIFICANT INFLATIONARY DANGER IN 1977 (SEE PARA 5); (C) SUBSTANTIAL EXCESS CAPACITY EXISTED IN MANUFACTURING SECTOR; (C) ACCELERATION IN INFLATION RATE IN FIRST QUARTER OF THIS YEAR LARGELY DUE TO INCREASES IN ADMINISTERED PRICES AND TO RISE IN PRICES OF SELECTED CONSUMPTION GOODS SUCH AS COFFEE, RATHER THAN TO DEMAND FACTORS; AND (E) STRICT CONTROLS ON PROFIT MARGINS WOULD MILITATE AGAINST ACCELERATION OF INFLATION FROM THIS SOURCE. THE YUGOSLAVS CONSIDERED INFLATION TARGET REALISTIC AND ACHIEVABLE. SECRETARIAT WAS SWAYED BY YUGOSLAV ARGUMENTS AND AGREED LIMITED OFFICIAL USE

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TO PLACE LESS EMPHASIS ON DANGER OF HIGHER INFLATION IN SHORT RUN. NEVERTHELESS, SECRETARIAT STRESSED THAT UNDERLYING RATE OF INFLATION IN YUGOSLAVIA WAS CLOSE TO 12 PERCENT AND THAT GOY MUST GIVE PRIORITY ATTENTION TO GETTING IT DOWN. YUGOSLAVS AND SECRETARIAT AGREED THAT REAL SOCIAL PRODUCT COULD GROW BY ABOUT 6 PERCENT IN 1977 AND SHOULD GENERATE 3 PERCENT RISE IN EMPLOYMENT (DISCUSSION OF UNEMPLOYMENT PROSPECTS IN SHORT AND MEDIUM-TERM WAS MINIMAL).

3. CURRENT ACCOUNT: NOTING THAT VALUE OF IMPORTS ROSE BY 32 PERCENT IN FIRST QUARTER OF 1977 COMPARED WITH RISE OF ONLY 18 PERCENT IN EXPORT VALUES, SECRETARIAT EXPRESSED VIEW THAT 1977 CURRENT ACCOUNT DEFICIT COULD WELL EXCEED \$400 MILLION PROJECTED BY YUGOSLAVS. YUGOSLAVS NOTED THAT LARGER INCREASE IN IMPORTS DURING FIRST

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QUARTER RESULTED PRIMARILY FROM TEMPORARY FACTORS (E.G., SEASONAL BULK PURCHASES OF CERTAIN COMMODITIES) AND THAT IMPORT GROWTH COULD BE EXPECTED TO DECELERATE CONSIDERABLY DURING REMAINDER OF YEAR. SECRETARIAT DID NOT REACT, BUT AGREED THAT PROSPECTIVE MAGNITUDE OF CURRENT ACCOUNT DEFICIT IN 1977 WAS NOT CAUSE FOR CONCERN. U.S. SUGGESTED THAT IN THESE CIRCUMSTANCES, THERE MIGHT BE SOME SCOPE FOR LIBERALIZATION OF IMPORT REGIME. YUGOSLAVS REPLIED THAT IMPORT REGIME WAS "LIBERAL ENOUGH" AND THAT MOVE TOWARD FURTHER LIBERALIZATION WAS NOT IN OFFING FOR NEAR FUTURE. (IN THIS CONTEXT, U.S. NOTED THAT HIGH RATE OF STOCKS TO SOCIAL PRODUCT -- 65 PERCENT -- COULD BE LINKED TO POSSIBLE TIGHTENING OF IMPORT CONTROLS. U.S. INTERVENTION MOTIVATED YUGOSLAVS TO REQUEST DELETION FROM REFDOC OF STOCK/SOCIAL PRODUCT RATIO ON GROUNDS THAT TECHNICAL PROBLEMS OF MEASUREMENT AND DEFINITION RENDERED THIS RATIO MEANINGLESS.)

4. YUGOSLAVS NOTED THAT REPUBLICS AND AUTONOMOUS PROVINCES WOULD BE ACCORDED INCREASED "BALANCE OF PAYMENTS
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RESPONSIBILITIES." THEY EXPLAINED THAT IN AREAS WHERE REPUBLICS HAVE AUTHORITY (E.G., PRICES, COLLECTIVE CONSUMPTION, INVESTMENT INCENTIVES) THEY SHOULD FOLLOW POLICIES CONSISTENT WITH BALANCE OF PAYMENTS OF OBJECTIVES OF THE COUNTRY AS A WHOLE. THEY ADDED THAT BANKS WOULD BE GIVEN FULL FREEDOM TO CONDUCT FOREIGN EXCHANGE OPERATIONS, ALTHOUGH EXCHANGE RATE WOULD CONTINUE TO BE SET BY CENTRAL GOVERNMENT. COLANOVIC INDICATED THAT YUGOSLAV WOULD CONTINUE POLICY OF PEGGING "EFFECTIVE" DINAR EXCHANGE RATE (IN EFFECT, THEY EXPLAINED, THIS WOULD MEAN PEGGING DINAR TO U.S. DOLLAR AND TO DM).

5. FISCAL AND MONETARY POLICY: YUGOSLAVS REITERATED OFFICIAL INTENTION TO REDUCE BUDGET DEFICIT IN 1977. EDRC DISCUSSION FOCUSED ON MONETARY POLICY WITH SEVERAL DELS AND SECRETARIAT POINTING TO INFLATIONARY RISK FOR 1977 POSED BY LAST YEAR'S 53 PERCENT INCREASE IN M1. YUGOSLAVS COMMENTED THAT THIS CONCERN WAS UNFOUNDED AND EXPLAINED THAT (A) ONE-SHOT INCREASE IN M1 WAS ATTRIBUTABLE TO FINANCIAL REFORMS IMPLEMENTED IN SPRING, 1976 UNDER WHICH AMOUNT OF INTER-ENTERPRISE CREDIT WAS SHARPLY REDUCED. FIRMS TURNED TO BANK CREDIT AS SUBSTITUTE FOR INTER-ENTERPRISE CREDIT AND AUTHORITIES DECIDED TO ACCOMMODATE THIS SHIFT. THIS CONSTITUTED SUBSTITUTION OF ONE FORM OF CREDIT FOR ANOTHER RATHER THAN A DRAMATIC INCREASE IN THE TOTAL VOLUME OF LIQUIDITY IN THE ECONOMY AND (B) DECENTRALIZATION PROCESS HAD INCREASED NUMBER OF ECONOMIC UNITS AND HAD THUS PRODUCED UPWARD SHIFT IN DEMAND FOR MONEY. EDRC AND SECRETARIAT WERE ONLY PARTLY SATISFIED BY YUGOSLAV EXPLANATION.

6. YUGOSLAVS FELT THAT SECRETARIAT'S CHARACTERIZATION OF THEIR CAPITAL MARKET AS "RUDIMENTAL" WAS INACCURATE AND THOUGHT THAT EMBRYONIC WOULD BE A MORE APT DESCRIPTION. THEY ADDED, HOWEVER, THAT RECENT INTRODUCTION OF COMMERCIAL BILLS WOULD BOTH IMPROVE ALLOCATION OF LIMITED OFFICIAL USE

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RESOURCES AND WOULD RESULT IN INCREASED FINANCIAL DISCIPLINE (CREDIT MUST BE LINKED TO PHYSICAL TRANSACTIONS). YUGOSLAVS ALSO PLAN TO ESTABLISH A MARKET FOR LONGER-TERM BONDS TO ASSIST THE FINANCING OF MAJOR INVESTMENT PROJECTS. SECRETARIAT AND U.S. NOTED THAT INTRODUCTION

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OF MORE FLEXIBLE INTEREST RATE POLICY WOULD BE SUPPORT-
IVE OF GOY EFFORTS TO BUILD AN EFFICIENT CAPITAL MARKET
AND WOULD ENHANCE EFFECTIVENESS OF MONETARY POLICY.
YUGOSLAVS WERE MUTE ON THIS POINT.

7. MEDIUM-TERM PROBLEMS AND POLICIES: YUGOSLAVS
STRESSED THAT ATTAINMENT OF THEIR MEDIUM-TERM OBJECTIVES
(E.G., CORRECTION OF REGIONAL IMBALANCES, ABSORPTION OF
RAPIDLY GROWING LABOR SUPPLY) WOULD REQUIRE ACCELERATION
OF INVESTMENT SPENDING. THEY FELT THAT LACK OF EFFICI-
ENT FINANCIAL INTERMEDIATION COULD CONSTITUTE MAJOR
IMPEDIMENT TO GROWTH OF INVESTMENT AND NOTED THAT RECENT
REFORMS AND INNOVATIONS WERE DESIGNATED TO ADDRESS THIS
PROBLEM. THEY DID NOT BELIEVE, HOWEVER, THAT DELAYS IN
SIGNING SOCIAL ACCORDS (E.G., IN ENERGY AND AGRIBUSINESS)
WOULD JEOPARDIZE FULFILLMENT OF MEDIUM-TERM GOALS IN THIS
AREA. THEY EXPLAINED THAT AGRIBUSINESS ACCORD IS NOW
READY TO BE SIGNED AND THAT WORK HAD PROCEEDED IN ENERGY
SECTOR IN ABSENCE OF ACCORD.

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8. SECRETARIAT MADE POINTED REFERENCE TO FACT THAT FIVE-
YEAR PLAN DID NOT EXPLICITLY TAKE INTO ACCOUNT PRICE AND
INCOMES DEVELOPMENTS. YUGOSLAVS DID NOT CONSIDER THIS
GAP TO BE A SERIOUS DEFICIENCY SINCE COURSE OF PRICES IN

YUGOSLAVIA WOULD, IN THEIR VIEW, BE DETERMINED BY INTERNATIONAL DEVELOPMENTS. EDRC CONCLUDED, HOWEVER, THAT COMBINING STEADY GROWTH WITH SUSTAINABLE CURRENT ACCOUNT POSITION WOULD REQUIRE VIGOROUS EFFORT TO MODERATE GROWTH OF WAGES AND PRICES.

9. QUESTIONS POSED REF D, PARAS 3A, 3B AND 3C ADDRESSED PARAS 7, 3 AND 4. POINTS RAISED REF C PARAS 2, 3, 4 AND 5 COVERED PARAS 5, 2 AND 3.
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